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U.S. Municipal Bond Market

Infrastructure Gap Barely Dented by Record 2020 Bond Sales, Expect Lower 2021 Issuance

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Summary

- We may see a record amount of municipal bond issuance by the end of 2020. Even on the low end, it could reach $450 billion, which was the estimate we published on Dec. 18, 2019.
- A severe infrastructure gap remains in the United States. We do not think this gap is going to influence issuers to sell more debt in 2021 compared to 2020.
- We expect overall municipal bond issuance will be down in 2021. Issuance is likely to fall to about $375 billion according to our analysis.
- Key reasons we are forecasting a year-over-year decrease: 1) issuance was accelerated into 2020, and 2) new money issuance going to fall because of revenue uncertainty and concerns about the strength of balance sheets.

A Record Amount of Overall Municipal Bond Issuance is Likely for 2020

We may see a record amount of municipal bond issuance by the end of 2020. Such a result is quite a surprise to many, especially considering the municipal bond market was essentially frozen between the middle of March and the middle of April due to the uncertainty stemming from the COVID-19 crisis. The pandemic and waves of shutdowns did not stop supply that came in well above average on a monthly basis beginning in June. To top it off, a recent Refinitiv tally had October 2020 issuance at $65 billion which is just under the $69 billion we saw in December 2017. December 2017 issuance spiked because of the Tax Cuts and Jobs Act of 2017.

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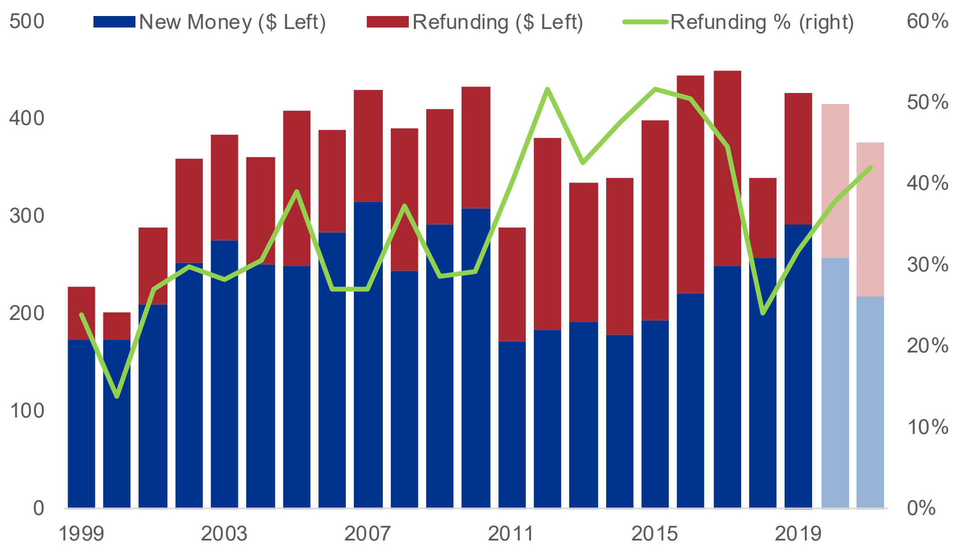
$415 Billion of Total Primary Municipal Issuance Through October 2020



Source: Refinitiv, The Bond Buyer, and HilltopSecurities.

Through the first 10 months of this year we have seen public finance issuers sell almost $415 billion. Total primary market bond sales for 2020 could total $450 billion assuming $15 billion of November issuance and another $20 billion in December, which are both low side estimates. $450 billion for 2020 would be exactly what we forecast back in our Dec. 18, 2019 report The U.S. Municipal Bond Market in 2020, in the Last Decade, and in the Next (see page 12). Municipal bond market issuance for the year was very much propped up by refunding activity, especially taxable refunding activity. New money issuance was still only about $260 billion through October of this year, and it is likely to fall in 2021.

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The U.S. Infrastructure Gap Continues

The significant United States infrastructure gap remains, even though 2020 will likely go down as a near-record or record year for municipal bond supply. Not much of a dent was made in the gap this year.

The state of U.S. infrastructure remains challenged. The American Society of Civil Engineers (ASCE) most recent Infrastructure Report Card was a D+. Organization after organization continues to quantify a costly U.S. infrastructure funding gap.

It is generally recognized that U.S. competitiveness would be increased if the backbone of the nation's infrastructure was made more efficient and reliable. Instead, ASCE continues to forecast the U.S. infrastructure gap at more than $2 trillion (needed by 2025). That gap would likely result in lost GDP of almost $4 trillion if not addressed, according to the ASCE.

Some saw the COVID-19 crisis and last several months of lawmaker negotiations as an opportunity to stimulate U.S. economic activity by providing resources for current infrastructure maintenance and by funding new infrastructure projects. Hope for additional funding was even a little higher when chances of a "Blue Wave" were stronger, and it was expected that infrastructure-focused legislation was expected to be prioritized as early as the first quarter of 2021 by Congress under such conditions.

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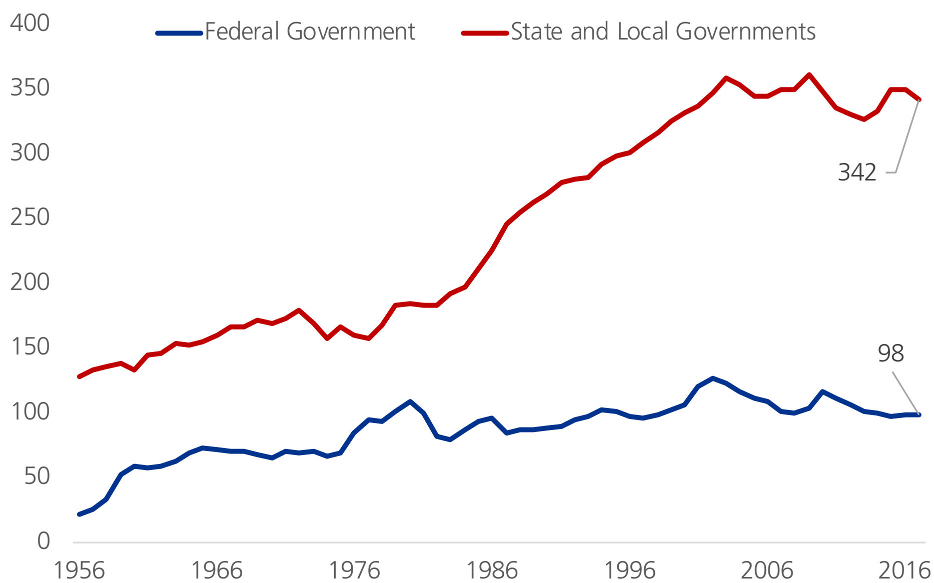
Infrastructure Burden on State and Local Governments

Washington, D.C. has increasingly placed the burden of funding infrastructure on state and local governments. The federal method of funding transportation infrastructure has largely been the Highway Trust Fund (HTF). The U.S. Interstate Highway System and the HTF were created by the Federal-Aid Highway Act of 1956. Now, the HTF funding mechanism is antiquated, faces a deficit in the billions and could be facing insolvency.

Public Spending on Transportation and Water Infrastructure by Level of Govt.



Source: CBO using data from OMB, the Census Bureau and the Bureau of Economic Analysis and HilltopSecurities (billions of 2017 dollars).

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No Signs for Significant COVID-19 Relief

The majority of infrastructure-related dollars has increasingly been coming from state and local governments. According to data from the Congressional Budget office, state and local governments have been spending a larger amount on transportation and water infrastructure projects than the federal government, for example. However, one method that the federal government uses to subsidize state and local government infrastructure is through the municipal bond tax-exemption tax expenditure (see page 2 of the CRS report).

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2021 Will be a Down Year, Led by Less New Money

Worse yet is that in 2021 we are expecting a step backward where total municipal bond issuance is concerned. We are forecasting overall municipal bond issuance will be down in 2021. Issuance is likely to fall to about $375 billion according to our analysis. That would be a $75 billion drop from the expected total 2020 issuance of $450 billion. We anticipate the percentage of refunding issuance will continue to rise because it is likely interest rates will stay low. Taxable issuance is going to continue to be utilized as well as it was in 2020.

HilltopSecurities U.S. Municipal Bond Issuance Forecast Breakdown

Type	Forecast for 2021 (in $)	Forecast for 2021 (% of Total)	Through Oct. 2020 (in $)	Through Oct. 2020 (% Total)
New Money	$217,500	58%	$257,426	62%
Refunding	$157,500	42%	$156,902	38%
Total	**$375,000**	**100%**	**$414,328**	**100%**
Tax-Exempt	$249,000	66%	$286,726	69%
Taxable	$126,000	34%	$127,601	31%
Total	**$375,000**	**100%**	**$414,328**	**100%**

Source: Refinitiv and HilltopSecurities.

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What may happen with the overall volume trajectory in 2021 could be very much like the dynamic we saw from 2011-2015. There are likely to be two key driving forces of municipal bond supply in 2021.

The first reason we believe issuance is going to be lighter in 2021 is because we believe that there was likely some issuance that was accelerated into 2020 as entities sought to take advantage of low interest rates before the election. This also means that issuance in the first three to four months of 2021 could be relatively lighter than the rest of the year too. A similar dynamic occurred in 2011 after Build America Bonds (BABs) expired at the end of 2010. It also occurred at the beginning of 2018 after issuance was accelerated into November and December of 2017 just before the Tax Cuts and Jobs Act of 2017. Please see the bar chart on the first page.

The second reason we expect issuance to fall is because state and local governments and other municipal bond issuers are likely going to approach 2021 cautiously. We think there is still a significant amount of uncertainty about what revenues could look like for the rest of FY21 and for the beginning of FY22. This revenue uncertainty means that adding additional debt service to annual expenditures is likely going to be less rather than more. This dynamic is also very much like what we saw from 2011 all the way to 2015 (please see the bar chart on page 1).

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We are often asked when we think the conditions will be right for new money to rise and rise substantially, especially considering the aforementioned U.S. infrastructure gap. We do not think new money issuance is going to be positioned to rise or rise noticeably unless there is a boost to GDP growth or additional revenues can be

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allocated toward new debt. We do not expect either of these conditions to develop in the near term, much less as soon as 2021. Unless economic growth gets back on track, we could end up seeing new money issuance near the sub-par levels we saw from 2011-2015.

Key Assumption, Divided Government Continues

We are assuming that the U.S. federal government remains divided in 2021, which is a key assumption we are using while making this issuance forecast. We reviewed how a divided government impacts several variables, including issuance, in our report, Election 2020: Results Will Impact the Economy, Markets and Municipal Bonds. Under a "Blue Wave" scenario, we expected an amount of issuance that would have most likely beat the 2020 record year. There is still a small chance Democrats take the Senate. For now, we await the results of the two Georgia Senate run-off elections. Therefore, if both Democrats win in Georgia we will revise and republish our forecast.

Bond Measures

Voter-approved bond measures can be additive to volume. Voters have weighed in on about $45 billion of bond issuance that could come to pass in the near term. However, it is important to remember that not all of this will be sold in 2021, as some financing plans occur over time. In addition, if credit conditions change, and the financial landscape deteriorates as some believe it could, then some of these projects could be postponed. In other words, just because the bonds were approved does not mean they will be sold.

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